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COMMENT

PICKING UP THE PIECES: THE EXCESS INSURER'S BAD FAITH CAUSE OF ACTION AGAINST THE PRIMARY INSURER

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I. INTRODUCTION

Although the bad faith cause of action by an insured against its insurer is recognized in Montana,[1] the Montana Supreme Court has not directly addressed a bad faith claim brought by an excess insurer against the primary insurer.[2] When a judgment exceeds the policy limit of the primary insurance policy, the excess insurer[3] will scrutinize the conduct of the primary insurer for elements of bad faith. For example, when confronted with a claim that exceeds its policy limits, the primary insurer may decide to litigate the claim because the primary insurer may have little or nothing to lose. At that point, the primary insurer is "gambling with either the excess carrier's money or the insured's money, or both."[4] Although Montana's courts have not addressed the issue of bad faith in terms of

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1. Fetter Livestock Co. v. National Farmers Union Property and Casualty Co., 257 F. Supp. 4, 10 (D. Mont. 1966); Jessen v. O'Daniel, 210 F. Supp. 317, 326-27 (D. Mont. 1962), *aff'd sub nom.* National Farmers Union Property and Casualty Co. v. O'Daniel, 329 F.2d 60, 64-65 (9th Cir. 1964); Gibson v. Western Fire Ins. Co., 210 Mont. 267, 274-75, 682 P.2d 725, 730 (1984).

2. *But see* St. Paul Fire & Marine Ins. Co. v. Allstate Ins. Co., ___ Mont. ___, ___, 847 P.2d 705, 709 (1993) (holding that an underinsurance carrier did not have a bad faith claim against a liability carrier because the insured had settled with the liability carrier).

3. The following definitions apply in this comment: (1) a primary insurer is the insurance carrier with initial responsibility for liability up to the policy limits; (2) an excess insurer is an insurance carrier responsible for the liability exceeding the primary policy limits up to the excess insurer's policy limits; and (3) the insured is the party who purchased the insurance coverage from the primary and excess carriers.

4. Gary M. Bloom, *Recovery Against Primary Insurer By Excess Carrier For Bad Faith Or Negligent Failure To Settle*, 36 INS. COUNS. J. 235, 237 (1969).

an excess insurer against a primary insurer, the courts have recognized an insurer's duties to settle the lawsuit and defend the insured.[5] This Comment examines the bad faith cause of action brought by an excess insurer against a primary insurer and describes the various duties that the primary insurer owes to the excess insurer.

In Montana, one of the first cases to define the duties owed by the primary insurer to the insured was *Jessen v. O'Daniel*.[6] In *Jessen*, Judge Jameson stated that "in determining whether a compromise offer of settlement should be accepted, the insurer must give the interests of its insured equal consideration with its own interests and must in all respects deal fairly with the insured."[7] *Jessen* set out six factors that would indicate bad faith by the insurer.[8] Along with the duty to settle, the Montana Supreme Court has recognized a cause of action based on the insurer's failure to defend.[9] As the court stated in *Lipinski Title Insurance Co.*, "the title companies by the terms of the contract, had a clear duty to defend Lipinski, and in breaching that clear duty the title companies acted in bad faith."[10] The Montana Unfair Claims Settlement Practices Act defines the procedural rules an insured must follow in pursuing a bad faith claim against the insurer.[11]

Although the primary insurer's duties to its insured are well defined, the Montana Supreme Court has yet to address the issue of bad faith between a primary and an excess insurer.[12] When faced with this issue the court will need to define the limits of the duty of good faith and fair dealing as well as determine which par-

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5. *Jessen*, 210 F. Supp. at 319. *See also* Lipinski v. Title Ins. Co., 202 Mont. 1, 16-17, 655 P.2d 970, 978 (1982).

6. 210 F. Supp. 319.

7. *Id.* at 325-26.

8. *Id.* at 326-27 (stating the factors as follows: (1) likelihood of a verdict in excess of policy limits, (2) whether a defendant's verdict on liability is doubtful, (3) whether the insurer has given due regard to the recommendations of its trial counsel, (4) whether the insured has been informed of all settlement demands and offers, (5) whether the insured has demanded that the insurer settle within policy limits, and (6) whether an offer of contribution has been made by the insured). The court stated that "no one factor is decisive." *Id.*

9. *Lipinski*, 202 Mont. at 16-17, 655 P.2d at 978.

10. *Id.*

11. MONT. CODE ANN. §§ 33-18-101 to -242 (1991).

12. Other jurisdictions have addressed this issue in a variety of circumstances. *See* Certain Underwriters of Lloyd's v. General Accident Ins. Co., 909 F.2d 228 (7th Cir. 1990) (personal injury); Commercial Union Ins. Co. v. Medical Protective Co., 393 N.W.2d 479 (Mich. 1986) (medical malpractice); Hartford Accident & Indem. Co. v. Michigan Mut. Ins. Co., 462 N.Y.S.2d 175 (App. Div. 1983) (worker's compensation); Maine Bonding & Casualty Co. v. Centennial Ins. Co., 693 P.2d 1296 (Or. 1985) (property damage liability policy); American Centennial Ins. Co. v. Canal Ins. Co., 810 S.W.2d 246 (Tex. Ct. App. 1991) (legal malpractice).

ties can recover on a bad faith claim.[13] Because Montana recognizes bad faith, the issue becomes "not *what* the basis of recovery will be against the insurer, but rather *who* may recover."[14]

This Comment describes potential situations in which primary and excess coverage[15] disputes may arise and then surveys the various legal theories that other jurisdictions use to support the bad faith cause of action by excess insurers.[16] After examining the duties owed by the primary insurer to the excess insurer, this Comment suggests a three-step analysis to define the duties owed by the primary insurer to the excess insurer. This Comment concludes that the appropriate legal theory for recovery is based on a direct duty owed by the primary insurer to the excess insurer.

II. PRIMARY AND EXCESS COVERAGE ISSUES

The issue of primary and excess claim coverage arises in two general situations. The first situation is termed the " 'true' primary-excess insurance relationship."[17] In this situation the insured carries two insurance policies: one providing primary coverage and the other excess coverage. The carrier issuing the excess policy is not liable for the amount covered by the primary policy, but is liable for amounts exceeding the primary policy limits.[18]

The second situation occurs when two separate policies cover two different insureds and one or both policies contain an "other insurance" clause.[19] A common example is a vehicle accident in which one policy insures the driver and another policy insures the vehicle.[20] Another example is a vehicle accident involving both

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13. 15A MARK S. RHODES, COUCH ON INSURANCE § 58:4 (rev. 2d ed. 1983 & Supp. 1992).

14. *See* Bloom, *supra* note 4, at 235 (emphasis in original).

15. Excess coverage is defined as a policy under which the insurer "is liable only for the amount of loss or damage in excess of the coverage provided by the other policy or policies of insurance." 16 MARK S. RHODES, COUCH ON INSURANCE § 62:48 (rev. 2d ed. 1983 & Supp. 1992).

16. The leading law review articles on the subject of bad faith between a primary insurer and an excess insurer are: Michael D. Gallagher & Edward C. German, *Resolution of Settlement Conflicts Among Insureds, Primary Insurers, and Excess Insurers: Analysis of the Current State of the Law and Suggested Guidelines for the Future*, 61 NEB. L. REV. 284 (1982); Patrick R. Griffin, *Excess Liability Insurance*, 62 MARQ. L. REV. 375 (1979); and Anthony M. Lanzone & Stephen G. Ringel, *Duties of a Primary Insurer to an Excess Insurer*, 61 NEB. L. REV. 259 (1982).

17. *See* Lanzone & Ringel, *supra* note 16, at 269.

18. 44 AM. JUR. 2D *Insurance* § 1789 (1982).

19. *See* Western Pac. Ins. Co. v. Farmers Ins. Exch., 416 P.2d 468 (Wash. 1966) (involving two insureds and two separate insurance policies). This situation is sometimes called a "coincidence case." Russo v. Rochford, 472 N.Y.S.2d 954, 957 (App. Div. 1984).

20. Phoenix Ins. Co. v. Nationwide Mut. Ins. Co., 335 F. Supp. 671 (D. Mont. 1972).

bodily injury liability coverage and uninsured motorist coverage.[21]

The Montana Supreme Court has dealt with separate policies covering both employer and employee.[22] In *Guaranty National Insurance Co. v. State Farm Insurance Co.*, the employee was involved in an accident while driving his own car, but was considered within the scope of his employment.[23] Once a court finds that a primary-excess insurance relationship exists, regardless of whether the relationship involves one insured with two policies or two insureds with separate policies, the court must determine which legal theory supports a bad faith cause of action.

III. Legal Theories Recognizing the Bad Faith Cause of Action

Courts recognizing bad faith actions instituted against primary insurers by excess insurers use one of four legal theories to support a recovery by the excess insurer despite the lack of privity between the excess and primary insurers: (1) equitable subrogation; (2) direct duty between the primary and excess carrier; (3) contractual subrogation; or (4) triangular reciprocal duty between the insured, the primary carrier, and the excess carrier.[24]

A. Equitable Subrogation

Most courts rely on the theory of equitable subrogation to overcome the lack of a contractual relationship (or privity) between the primary insurer and the excess insurer.[25] This theory was first implicitly recognized in *American Fidelity & Casualty Co. v. All American Bus Lines Inc.*[26] The Tenth Circuit stated that:

> [T]he equities between the two companies were not equal; that [the primary insurer] was allegedly guilty of bad faith while [the excess insurer] was at most guilty of breach of contract; and that, as between the two, it would be just and equitable for American

21. Sullivan v. Doe, 159 Mont. 50, 495 P.2d 193 (1972). *See also* St. Paul Fire & Marine Ins. Co. v. Allstate Ins. Co., ___ Mont. ___, ___, 847 P.2d 705, 709 (1993) (not ruling on whether underinsured motorist coverage was in excess of primary liability coverage in a motor vehicle accident).

22. Guaranty Nat'l Ins. Co. v. State Farm Ins. Co., 238 Mont. 324, 777 P.2d 353 (1989).

23. *Id.* at 327, 777 P.2d at 355.

24. *See* Gallagher & German, *supra* note 16, at 334.

25. Griffin, *supra* note 16, at 379. *See generally* C.C. Marvel, Annotation, *Right to Subrogation, as Against Primary Insurer, of Liability Insurer Providing Secondary Insurance*, 31 A.L.R.2d 1324 (1953 & Supp. 1992).

26. 190 F.2d 234 (10th Cir.), *cert. denied*, 342 U.S. 851 (1951).

to bear the loss occasioned by its own misconduct."[27]

A California Federal District Court articulated a better explanation of equitable subrogation in *Peter v. Travelers Insurance Co.*[28] In *Peter*, the primary insurer refused to consider any offer over $15,000 in settlement of a personal injury claim.[29] The primary insurer's policy limit was $250,000.[30] The jury awarded the injured party $407,000.[31] Following trial the parties compromised the claim with the excess insurer paying $137,984.10 over the primary insurer's limits.[32] The excess insurer then brought a bad faith claim against the primary insurer.[33] In holding for the excess insurer, the court relied on the doctrine of equitable subrogation to support a bad faith cause of action against the primary insurer.[34] The court quoted an earlier California case for the elements of equitable subrogation:

> (1) The insured has suffered a loss for which the party to be charged is liable, either because the latter is a wrongdoer whose act or omission caused the loss or because he is legally responsible to the insured for the loss caused by the wrongdoer; (2) the insurer, in whole or in part, has compensated the insured for the same loss for which the party to be charged is liable; (3) the insured has an existing, assignable cause of action against the party to be charged, which action the insured could have asserted for his own benefit had he not been compensated for his loss by the insurer; (4) the insurer has suffered damages caused by the act or omission upon which the liability of the party to be charged depends; (5) justice requires that the loss should be entirely shifted from the insurer to the party to be charged, whose equitable position is inferior to that of the insurer; and (6) the insurer's damages are in a stated sum, usually the amount it has paid to its insured, assuming the payment was not voluntary and was reasonable.[35]

Additionally, the court in *Peter* found that the primary insurer's reluctance to negotiate for a settlement over the $15,000 figure was the proximate cause of the excess insurer's $137,984.10 loss.[36]

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27. *Id.* at 238.
28. 375 F. Supp. 1347 (C.D. Cal. 1974).
29. *Id.* at 1348.
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.* at 1349-50.
35. *Id.* at 1350 (quoting Patent Scaffolding Co. v. William Simpson Constr. Co., 64 Cal. Rptr. 187, 190 (Ct. App. 1967)).
36. *Id.*

Although not in the primary-excess insurer context, the Montana Supreme Court has recognized equitable subrogation between an insurer and its insured.[37] The court in *Skauge v. Mountain States Telephone & Telegraph Co.* held that an insurer, who had paid for the insured's loss, was subrogated to the extent of its payment to its insured as long as the insured had been "made whole for his entire loss."[38] In *Skauge*, the insured was proceeding with a claim against the alleged tortfeasor.[39] The court classified subrogation as either legal or conventional.[40] Legal subrogation arises because of payment made by the insurer, whereas conventional subrogation arises from the contract between the parties.[41] This distinction has no legal significance in most cases because the same facts supporting legal subrogation also support conventional subrogation.[42] The court expressed the following policy in support of equitable subrogation:

> The theory behind this principle is that absent repayment of the insurer the insured would be unjustly enriched by virtue of recovery from both the insurer and the wrongdoer, or in absence of such double recovery by the insured, the third party would go free despite his legal obligation in connection with the loss.[43]

Finally, the court held that "an express assignment of the claim to [the insurer] was unnecessary, since legal subrogation arose from the fact of payment, and this was not waived or made conditional by agreement of the parties."[44] Therefore, the basis for recovery under equitable subrogation is already established in Montana law.[45]

Other courts have applied the equitable subrogation theory to primary and excess carrier cases. For example, the Arizona Supreme Court recently adopted the theory of equitable subrogation between primary and excess carriers.[46] There, the court discussed two important policy reasons to support its holding. First, equita-

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37. Skauge v. Mountain States Tel. & Tel. Co., 172 Mont. 521, 565 P.2d 628 (1977).
38. *Id.* at 528, 565 P.2d at 632.
39. *Id.* at 523, 565 P.2d at 629.
40. *Id.* at 525, 565 P.2d at 630.
41. *Id.*
42. 16 MARK S. RHODES, COUCH ON INSURANCE § 61:2 (rev. 2d ed. 1983 & Supp. 1992).
43. *Skauge*, 172 Mont. at 524-25, 565 P.2d at 630 (citing 16 COUCH ON INSURANCE 2D § 61:18).
44. *Id.* at 526, 565 P.2d at 631.
45. *But see* MONT. CODE ANN. § 39-71-414 (1991) (explaining limitations on Workers' Compensation subrogation); Allstate Ins. Co. v. Reitler, 192 Mont. 351, 355, 628 P.2d 667, 670 (1981) (prohibiting subrogation of medical payments made under an automobile policy).
46. Hartford Accident & Indem. Co. v. Aetna Casualty & Sur. Co., 792 P.2d 749, 754 (Ariz. 1990).

ble subrogation encourages fair and reasonable settlement of lawsuits because primary insurers are more likely to settle if they face a bad faith charge by an excess insurer.[47] Second, equitable subrogation prevents unfair distribution of losses between primary and excess insurers when the excess insurer settles the claim and the primary insurer refuses to contribute to the settlement.[48]

Although the Montana Supreme Court has not dealt with a bad faith claim between a primary and an excess carrier, the court has implied that it would adopt equitable subrogation.[49] In *St. Paul Fire & Marine Insurance Co. v. Allstate Insurance Co.*, the insured carried underinsured motorist coverage with St. Paul Fire and Marine Insurance Company.[50] The insured was injured in an automobile accident caused by an insured of Allstate Insurance Company.[51] After a jury trial, Allstate paid its policy limit and St. Paul paid the balance of the judgment under the underinsured motorist coverage.[52] St. Paul then sued Allstate for refusing to settle the case for Allstate's policy limits.[53] The Montana Supreme Court held that even if it recognized equitable subrogation, St. Paul could not recover because the insured had previously sued Allstate for its bad faith refusal to settle the case.[54] Because the insured's bad faith claim against Allstate had been dismissed, St. Paul was not equitably subrogated to the same bad faith claim.[55]

The extent of the excess insurer's rights as a subrogee has been defined by the Seventh Circuit.[56] The Seventh Circuit held that the excess insurer "stands in the shoes of the insured,"[57] but "acquires no greater or lesser rights than those possessed by the subrogor."[58] This gives rise to the situation in which an insured's misconduct, such as failing to cooperate, may defeat the excess insurer's right to recovery.[59] One method of overcoming this weak-

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47. *Id.* at 753.

48. *Id.*

49. *See* St. Paul Fire & Marine Ins. Co. v. Allstate Ins. Co., ___ Mont. ___, ___, 847 P.2d 705, 709 (1993).

50. *Id.* at ___, 847 P.2d at 706.

51. *Id.* at ___, 847 P.2d at 706.

52. *Id.* at ___, 847 P.2d at 706.

53. *Id.* at ___, 847 P.2d at 706.

54. *Id.* at ___, 847 P.2d at 709.

55. *Id.* at ___, 847 P.2d at 709.

56. *See* Certain Underwriters of Lloyd's v. General Accident Ins. Co. of Am., 909 F.2d 228, 232 (7th Cir. 1990).

57. *Id.* (quoting Commercial Union Assurance Cos. v. Safeway Stores, Inc., 610 P.2d 1038, 1041 (Cal. 1980)).

58. *Id.*

59. *See* Puritan Ins. Co. v. Canadian Universal Ins. Co., 775 F.2d 76, 80-81 (3d Cir. 1985) (holding that the insured's consent to try the case barred the excess carrier from

ness in the subrogation theory is to impose a direct duty between the primary insurer and the excess insurer so that the insured's misconduct does not bar the excess insurer from recovery.[60]

B. Direct Duty Between the Primary and the Excess Carrier

The second method of overcoming the lack of privity between primary and excess carriers imposes a tort related duty on the primary insurer. In *Ranger Insurance Co. v. Home Indemnity Co.*,[61] an Illinois Federal District Court recognized that, although equitable subrogation would normally apply, the excess insurer had failed to put the primary insurer on notice that the excess insurer's bad faith claims were based on subrogated rights.[62] Thus, the court looked to tort law to impose a duty of care when "the alleged tortfeasor could have reasonably foreseen that its conduct would injure the plaintiff and policy considerations justify placing the risks and the burden of care on the defendant."[63]

Other state courts have analyzed the direct duty theory. A New York court stated that it "does not alter the defense obligation which *each* carrier . . . owe[s] to the common insured with whom each has a contract, or the responsibility that . . . an excess carrier has to assist the primary in the defense of a claim against the insured."[64] Likewise, a New Jersey court found a direct duty to settle by holding that "the primary carrier owes to the excess carrier the same positive duty to take the initiative and attempt to negotiate a settlement within its policy limit that it owes its [insured]."[65] Similarly, the Oregon Supreme Court, in *Maine Bonding & Casualty Co. v. Centennial Insurance Co.*,[66] discussed the various duties that a primary carrier owes an excess carrier:

> A primary insurer owes an excess insurer essentially the same duty of due diligence in claims handling and settlement negotiating it owes to an insured—due care under all the circumstances. In considering the manner in which it will defend a claim, the primary insurer may consider its own interests, but it must also consider the interests of other parties whose interests are in-

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asserting a bad faith claim against the primary carrier under equitable subrogation).

60. *Certain Underwriters*, 909 F.2d at 233.

61. 714 F. Supp. 956 (N.D. Ill. 1989).

62. *Id.* at 960. *See also* Hartford Accident and Indem. Co. v. Michigan Mut. Ins. Co., 462 N.Y.S.2d 175 (App. Div. 1983), *aff'd*, 463 N.E.2d 608 (N.Y. 1984).

63. *Ranger Ins. Co.*, 714 F. Supp. at 961.

64. Russo v. Rochford, 472 N.Y.S.2d 954, 959 (App. Div. 1984) (emphasis in original).

65. Estate of Penn v. Amalgamated Gen. Agencies, 372 A.2d 1124, 1127 (N.J. Super. Ct. App. Div. 1977).

66. 693 P.2d 1296 (Or. 1985).

volved, notably, the insured and the excess carrier.[67]

Although at first blush the direct duty theory appears to differ significantly from equitable subrogation, in reality a bad faith claim arises from the tort principle of a duty owed by the insurer to its insured. "As long as the scope of the duty is appropriately defined, the primary carrier is not held to a standard of care that it did not already owe to the insured."[68] Thus, the Montana Supreme Court could logically apply the same duty standard owed by primary insurers to insureds and extend it to excess insurers.

C. *Contractual Subrogation*

Recovery under contractual subrogation is based on the standard subrogation clause found in most insurance contracts to support a bad faith cause of action between a primary carrier and an excess carrier. In *Allstate Insurance Co. v. Reserve Insurance Co.*,[69] the New Hampshire Supreme Court first faced the issue of whether an excess carrier had a bad faith cause of action against the primary carrier. The insured had primary coverage with Reserve and excess coverage with Allstate.[70] Following a jury award that exceeded the primary policy limits, Allstate sued Reserve, alleging that Reserve negligently failed to settle the claim within its policy limits.[71] Allstate sued, in the alternative, on the standard subrogation clause and under general principles of negligence, claiming Reserve owed a direct duty of due care to Allstate.[72]

In rejecting the negligence claim, the New Hampshire Supreme Court stated, "[w]e perceive no relationship between the two insurers which would impose directly upon Reserve a duty to exercise due care in regard to Allstate."[73] The court did allow Allstate's cause of action based on the standard subrogation clause because it was an assignable cause of action recognized under New Hampshire law.[74] Finally, the court held that the assignment from the insured to Allstate was effective even though the insured had not suffered any loss.[75] Thus, contractual subrogation simply relies on the language of the insurance contract.

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67. *Id.* at 1302.
68. *Ranger Ins. Co.*, 714 F. Supp. at 961.
69. 373 A.2d 339 (N.H. 1976).
70. *Id.* at 340.
71. *Id.*
72. *Id.*
73. *Id.*
74. *Id.*
75. *Id.*

D. *Triangular Reciprocity*

The triangular reciprocity theory holds that all three parties (the insured, the primary insurer, and the excess insurer) owe reciprocal duties to each other. In *Transit Casualty Corp. v. Spink Corp.*[76] the California Court of Appeals found a three-way duty between the insured, the primary carrier, and the excess carrier.[77] The insured, an engineering firm, refused to contribute its deductible toward settlement of a wrongful death claim because settlement would injure its professional reputation.[78] The primary policy required the insured's written consent to settle claims.[79] After losing at trial, Transit, the excess carrier, brought suit against its insured and the primary carrier for refusing to settle.[80]

In affirming judgment for the excess carrier, the court found that "[t]he implied covenant of good faith and fair dealing does not burden the carrier alone; it is reciprocal, binding the policy holder as well as the carrier."[81] In analyzing equitable subrogation, the court addressed the problem caused by the insured's refusal to settle because the subrogee's (excess carrier's) rights cannot rise any higher then the subrogor's (insured's) rights.[82] Thus, under principles of equitable subrogation, the excess insurer's claim would fail. The court reasoned that resorting "to equitable subrogation as the foundation of the excess insurer's claim tends toward undesirable, all-or-nothing results."[83]

The court in *Transit* relied on principles of negligence to support the duty that flowed between the three parties.[84] These principles include reasonably foreseeable harm creating a duty of care, comparative negligence, and apportionment of liability between the defendants.[85] These three principles represent reciprocal duties of care which should guide the parties' conduct during settlement negotiations.[86]

The triangular reciprocity theory was short-lived. Less than one year after the Court of Appeals decided *Transit*, the California Supreme Court overruled *Transit* in *Commercial Union Assurance*

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76. 156 Cal. Rptr. 360 (Ct. App. 1979).
77. *Id.* at 366.
78. *Id.* at 364.
79. *Id.* at 363.
80. *Id.* at 364.
81. *Id.*
82. *Id.* at 365.
83. *Id.* at 366.
84. *Id.*
85. *Id.*
86. *Id.*

Cos. v. Safeway Stores, Inc.[87] Although the court conceded that the duty of good faith and fair dealing was reciprocal, the court eliminated the duty to settle on the part of the insured.[88] In *Commercial Union*, the excess carrier sued both the primary carrier and the insured for failure to settle.[89] The insured provided self-insurance coverage between the primary policy and the excess policy.[90] The court explained that the extent of the good faith duty was defined both by the nature of the bargain between the insurer and the insured and by the legitimate expectations arising from the contract.[91] In defining the duty of good faith the court stated:

> The insured owes no duty to defend or indemnify the excess carrier; hence, the carrier can possess no reasonable expectation that the insured will accept a settlement offer as a means of "protecting" the carrier from exposure. The protection of the insurer's pecuniary interests is simply not the object of the bargain.[92]

The court concluded that if an excess carrier wished to preserve the right to recover from the insured for refusing to settle, the excess carrier must put appropriate language in the insurance contract.[93] Under *Commercial Union* the excess insurer's only source of recovery is the primary insurer.

Given the proper case, the Montana Supreme Court should decide the appropriate legal theory to employ. The court's next step will then be to determine the duties the primary insurer owes to the excess insurer.

IV. Primary Insurer's Duties

Outside Montana, primary insurers generally owe five duties to excess insurers: The duty to (1) defend, (2) appeal, (3) communicate, (4) cooperate, and (5) settle.[94] These are the same duties that the primary insurer owes its insured.[95]

A. Duty to Defend

The language in insurance contracts usually states, and most courts generally hold, that the primary insurer has the duty to de-

87. 610 P.2d 1038, 1043 (Cal. 1980).
88. *Id.* at 1042.
89. *Id.* at 1040.
90. *Id.*
91. *Id.* at 1041.
92. *Id.* at 1041-42.
93. *Id.* at 1043.
94. *See* Griffin, *supra* note 16, at 383-88.
95. *See id.* at 382.

fend.[96] Most insurance contracts provide that the duty to defend ceases upon payment of policy limits, either by judgment or settlement.[97] The Montana Supreme Court recognized this duty between insureds and their primary carriers in Montana in *Lipinski v. Title Insurance Co.*[98]

The Montana Supreme Court has defined the scope of the primary insurer's duty to defend in *St. Paul Fire and Marine Insurance Co. v. Thompson.*[99] In *Thompson* the insured sued his carrier after the carrier refused to defend the insured in a subrogation action brought by a joint tortfeasor.[100] Because the carrier had paid the policy limits, the carrier argued that it no longer had a duty to defend its insured.[101] The court rejected this argument and held that a duty to defend attached even after the carrier had paid the policy limits.[102] It further stated that the duty to defend is "independent of, and broader than the insurer's promise to pay."[103] Therefore, under *Thompson* the initial duty to defend is logically placed on the primary carrier because the primary carrier usually conducts the investigation and settlement negotiations.[104]

Some courts have found, however, that the excess carrier also has a duty to defend. In *Lujan v. Gonzales*,[105] the driver of a pickup struck and killed a pedestrian.[106] Allstate insured the driver and Farmers Insurance Group insured the pickup.[107] Although Allstate was an excess insurer, the New Mexico Court of Appeals held that Allstate still had a duty to participate in the defense even though Farmers was actively defending Gonzales.[108] The court reasoned that under the policy language Allstate had a duty to defend false claims in which there was no obligation to pay.[109] Therefore,

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96. Macloskie v. Royal Indem. Co., 254 F. Supp. 782, 792 (D. S.C. 1966) (holding that the primary insurer was fully responsible for defending the insured and the excess carrier had no such responsibility). *See generally* Jane M. Draper, Annotation, *Liability Insurance: Excess Carrier's Right of Action Against Primary Carrier for Improper or Inadequate Defense of Claim*, 49 A.L.R.4TH 304 (1986 & Supp. 1992).

97. 7C JOHN ALAN APPLEMAN, INSURANCE LAW AND PRACTICE § 4682 (Walter F. Berdal ed., 1979).

98. 202 Mont. 1, 655 P.2d 970 (1982).

99. 150 Mont. 182, 433 P.2d 795 (1967).

100. *Id.* at 184, 433 P.2d at 797.

101. *Id.*

102. *Id.* at 188, 433 P.2d at 799.

103. *Id.*

104. *See* Russo v. Rochford, 472 N.Y.S.2d 954, 960 (App. Div. 1984).

105. 501 P.2d 673 (N.M. Ct. App. 1972).

106. *Id.* at 675.

107. *Id.*

108. *Id.* at 677.

109. *Id.*

the duty to defend arose because a potential for payment existed.[110]

The Montana Supreme Court, in *Guaranty National Insurance Co. v. State Farm Insurance Co.*,[111] ordered the primary carrier to indemnify the excess carrier when the excess carrier settled the lawsuit.[112] The court first decided that an employee's vehicle insurance carrier provided primary coverage and the employer's insurance carrier provided excess coverage.[113] The underlying claim arose from a car accident in which the employee, while driving his personal vehicle in the scope of his employment, killed one person and injured another.[114] During trial, the excess carrier successfully moved to join the primary carrier in its defense of the employer after the district court dismissed the employee.[115] The excess carrier then settled the suit on the eve of the last day of trial.[116] In support of its holding the court stated that the excess carrier "was bound by a fiduciary duty to settle the case and will not now be penalized for fulfilling its contractual and fiduciary obligations."[117]

The scope of the excess carrier's duty to defend is not clear from the preceding cases. In *Guaranty National Insurance*, the Montana court based its decision on the contract language of the two policies. The court in *Lujan*, on the other hand, cited an Arkansas case which implied that an excess carrier need defend only if the excess carrier's insured would potentially be exposed to excess liability.[118] The best approach to defining the duty to defend is to extend the duty to the excess carrier when the claim exceeds the primary policy limits. Under this approach, the excess carrier can adequately protect both its interests and the insured's interests.

The primary carrier that wrongfully refuses to defend may be held liable for the defense costs. In *Western Pacific Insurance Co. v. Farmers Insurance Exchange*,[119] the Washington Supreme

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110. *Id.*

111. 238 Mont. 324, 777 P.2d 353 (1989).

112. *Id.* at 330, 777 P.2d at 357.

113. *Id.* at 329, 777 P.2d at 356.

114. *Id.* at 326, 777 P.2d at 354.

115. *Id.* (The district court dismissed the employee because he was acting within the scope of his employment.).

116. *Id.*

117. *Id.* at 330, 777 P.2d at 357.

118. Southern Farm Bureau Casualty Ins. Co. v. Allstate Ins. Co., 150 F. Supp. 216, 220 (W.D. Ark. 1957).

119. 416 P.2d 468 (Wash. 1966). *See generally* Annotation, *Allocation of Defense Costs Between Primary and Excess Insurance Carriers*, 19 A.L.R.4TH 107 (1983 & Supp. 1992).

Court held the primary carrier liable to the excess carrier for the costs of defending the lawsuit.[120] Like *Guaranty National Insurance*, the primary carrier in *Western Pacific Insurance Co.* insured the vehicle while the excess carrier insured the driver.[121] The Washington Supreme Court held that the primary insurer could not refuse to defend based on its own unilateral decision that its policy did not cover the accident which was the basis of the lawsuit.[122]

The issue of apportioning defense costs between a primary carrier and an excess carrier has arisen in the Montana Federal District Court. In *Liberty Mutual Insurance Co. v. United States Fidelity & Guaranty Co.*,[123] the Montana Federal District Court prorated defense costs between two primary insurers.[124] The court also held the two insurers pro rata liable for the settlement.[125]

In *American States Insurance Co. v. Angstman Motors, Inc.*[126] the Montana Federal District Court relied on *Liberty Mutual* and prorated defense costs between a primary and an excess carrier.[127] In *American States*, Angstman Motors arranged for a prospective buyer to test drive a grain truck.[128] Before purchasing the truck, however, the prospective buyer's employee was involved in an accident while driving the truck.[129] The court found that Angstman Motors' insurance policy provided primary coverage and the prospective buyer's insurance policy provided excess coverage.[130] The *Angstman* decision is arguably incorrect because, although both policies provided primary coverage, the court interpreted one policy as excess coverage due to an "Other Insurance" clause.[131] Thus, the *Liberty Mutual* rule was inapplicable.[132]

The equitable approach to this issue is to pro rate the costs of defending based on the contributions that each carrier tenders to-

120. *Western Pacific Ins. Co.*, 416 P.2d at 472.
121. *Id.* at 469.
122. *Id.* at 472.
123. 232 F. Supp. 76 (D. Mont. 1964).
124. *Id.* at 84-85.
125. *Id.*
126. 343 F. Supp. 576 (D. Mont. 1972).
127. *Id.* at 587.
128. *Id.* at 579.
129. *Id.*
130. *Id.* at 586.
131. *Id.*
132. The issue of prorating defense costs between a primary and an excess insurer in Montana is currently on appeal to the Ninth Circuit. *See* Guaranty Nat. Ins. Co. v. American Motorists Ins. Co., 758 F. Supp. 1394 (D. Mont. 1991). In *Guaranty National*, Judge Hatfield ordered a pro rata division between the primary and excess insurer of costs incurred while defending their common insured. *Id.* at 1398.

ward the settlement or final judgment. This gives each carrier an incentive to cooperate and to bargain for the lowest settlement or prepare the best defense at trial.

B. Duty to Appeal

Although most insurance policies do not contain provisions requiring an insurer to appeal, the general rule is that a duty to appeal exists when there are reasonable grounds for an appeal.[133] In *Fidelity General Insurance Co. v. Aetna Insurance Co.*[134] the primary insurer refused to appeal the trial verdict. The excess insurer stepped in and pursued the appeal.[135] In granting relief to the excess carrier, the New York Supreme Court, Appellate Division, held that an excess carrier is entitled to reimbursement for discharging the primary insurer's duty to appeal.[136] The court found a legitimate basis for an appeal and thus, under the insurance policy's covenant to defend, the primary carrier was obligated to pursue an appeal.[137] Placing the duty to appeal on the primary insurer is logical because the primary insurer generally conducts the litigation precipitating the appeal.

C. Duty to Communicate

The law imposes a duty upon a primary insurer to keep its insured informed.[138] In *Wooster v. Midcentury Insurance Co.*[139] the insurer failed to inform its insured that it had settled for policy limits but had not obtained a release of the insured.[140] The California Court of Appeals reversed summary judgment for the insurer and held:

> [A]n insurer, when it is faced with a claim for amounts over the policy limit, and when it is unable to obtain a general release of its insured even if it pays the policy limits, must let its insured know that it intends to pay the policy limits, or the final portion thereof, and must cooperate with the insured and give the insured

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133. *See* Griffin, *supra* note 16, at 385.
134. 278 N.Y.S.2d 787 (App. Div. 1967).
135. *Id.* at 788.
136. *Id.*
137. *Id.*
138. Boston Old Colony Ins. Co. v. Gutierrez, 386 So.2d 783, 785 (Fla. 1980) (listing several duties owed by the insurer, such as advising the insured of settlement opportunities, advising the insured as to the probable outcome of the litigation, warning the insured of excess judgment, and advising the insured of any steps that it might take to avoid an excess judgment).
139. 271 Cal. Rptr. 664 (Ct. App. 1990).
140. *Id.* at 665.

> a reasonable opportunity to participate in an attempt to make a joint settlement of the claim.[141]

Although *Wooster* did not involve an excess insurer, the same duty should apply between a primary insurer and an excess insurer.[142] The excess insurer merely replaces the insured for claims exceeding the primary policy up to the outer limits of the excess policy.[143] Common sense mandates that the primary insurer inform the excess insurer whenever the claim exceeds the primary policy limits.

D. Duty to Cooperate

Closely related to the duty to communicate is the duty to cooperate. In *United States Fire Insurance v. Morrison Assurance*,[144] the Florida District Court of Appeals affirmed a verdict for the excess insurer on its bad faith claim against the primary insurer.[145] The court reasoned that:

> [d]espite a request from [the excess insurer], [the primary insurer] failed to communicate the status of this case for eighteen months. [The excess insurer] was not advised as to the settlement negotiations, the probable outcome of the litigation, or the possibility of an excess judgment; nor was it given any input into steps that could be taken to avoid an excess judgment.[146]

The court held that although the insured had been informed and in fact consented to the trial, those actions did not operate as a defense to the excess insurer's bad faith claim.[147] Recognizing a duty to cooperate is merely another method of reducing the costs of litigation and encouraging the prompt settlement of claims.

E. Duty to Settle

The insurer's duty to its insured to settle has been part of Montana law since *Jessen v. O'Daniel*.[148] The Montana Federal

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141. *Id.* at 673-74.

142. *See* Griffin, *supra* note 16, at 387. For a contrary holding, see Smoral v. Hanover Ins. Co., 322 N.Y.S.2d 12, 14 (App. Div. 1971) (holding that a primary carrier had no duty to keep an excess carrier informed).

143. *See, e.g.*, Continental Casualty Co. v. Reserve Ins. Co., 238 N.W.2d 862, 864 (Minn. 1976) ("If the insured purchases excess coverage, he in effect substitutes an excess insurer for himself.").

144. 600 So.2d 1147 (Fla. Dist. Ct. App. 1992).

145. *Id.* at 1153.

146. *Id.* at 1151.

147. *Id.* at 1152-53.

148. *See* Gibson v. Western Fire Ins. Co., 210 Mont. 267, 274, 682 P.2d 725, 730 (1984).

District Court in *Jessen* stated that "in determining whether a compromise offer of settlement should be accepted, the insurer must give the interests of its insured equal consideration with its own interests and must in all respects deal fairly with the insured."[149]

Other jurisdictions have extended this duty to excess insurers.[150] In *Peter*, the California Federal District Court stated that "[u]nder the doctrine of equitable subrogation, the duty owed an excess insurer is identical to that owed the insured."[151] Courts finding existing duties between the primary and the excess carriers have included among those duties the duty to settle.[152]

V. A Proposed Analysis of the Bad Faith Cause of Action

The Montana Supreme Court should employ a three-step analysis when examining an excess insurer's bad faith cause of action against a primary insurer. The first step of this analysis is to establish that a primary-excess carrier relationship exists. Next, the court must choose a legal theory to support the bad faith cause of action. Finally, the court must determine which duty or duties the primary carrier failed to perform. This three-step analysis provides a logical means of analyzing the various issues comprising a bad faith cause of action. These issues include the two contexts in which a bad faith cause of action occurs, the four legal theories used to support this cause of action, and the five duties owed by the primary insurer to the excess insurer.

The first step in this analysis is to determine if a primary-excess relationship exists between the two carriers. This can be resolved by determining whether there is one insured covered by two policies or two insureds covered by two separate policies.[153] Once

149. *Id.* at 325-26.

150. *See* Insurance Co. of N. Am. v. Medical Protective Co., 768 F.2d 315, 320 (10th Cir. 1985) (applying Kansas law); Vencill v. Continental Casualty Co., 433 F. Supp. 1371, 1376 (S.D. W. Va. 1977); Ranger Ins. Co. v. Travelers Indem. Co., 389 So.2d 272, 274 (Fla. Dist. Ct. App. 1980); Fireman's Fund Ins. Co. v. Continental Ins. Co., 519 A.2d 202, 204 (Md. 1987); Commercial Union Ins. Co. v. Medical Protective Co., 393 N.W.2d 479, 483 (Mich. 1986); Continental Casualty Co. v. Reserve Ins. Co., 238 N.W.2d 862, 864 (Minn. 1976); Centennial Ins. Co. v. Liberty Mut. Ins. Co., 404 N.E.2d 759, 762 (Ohio 1980).

151. Peter v. Travelers Ins. Co., 375 F. Supp. 1347, 1350 (C.D. Cal. 1974).

152. *Vencill*, 433 F. Supp. at 1377 ("It is the affirmative duty of an insurer to pursue serious negotiations, particularly in the case with which [the primary insurer] was confronted.") (citations omitted). *See also* Ranger Ins. Co. v. Home Indem. Co., 714 F. Supp. 956, 960 (N.D. Ill. 1989); Annotation, *Excess Carrier's Right to Maintain Action Against Primary Liability Insurer for Wrongful Failure to Settle Claim Against Insured*, 10 A.L.R.4TH 879 (1981 & Supp. 1992).

153. *See supra* text accompanying notes 17-23.

the primary-excess carrier relationship is established, the next step is to choose the appropriate legal theory.

Although most courts have adopted the equitable subrogation legal theory,[154] the better approach is to recognize a direct duty between the primary carrier and the excess carrier.[155] The direct duty legal theory allows an excess carrier to recover even though the insured engaged in culpable conduct that would destroy the excess carrier's bad faith claim under equitable subrogation.[156]

By imposing a direct duty on the primary insurer to exercise that degree of care "as would have been used by an ordinarily prudent insurer with no policy limit applicable to the claim,"[157] the court can apportion liability between the primary insurer and the excess insurer based on principles of comparative negligence. Comparative negligence is appropriate because the primary and excess carrier share common obligations to the insured such as claims adjustment, settlement, and defense responsibilities.[158]

Under limited circumstances, the insured should also be held liable for breaching the duty of good faith and fair dealing. In *Kaiser Foundation Hospitals v. North Star Reinsurance Corp.*[159] the California Court of Appeals held that both the insured and the primary carrier owed the duty of good faith and fair dealing to the excess carrier.[160] In *Kaiser Foundation Hospitals* the insured and the primary carrier allegedly fraudulently assigned the dates of malpractice claims so that the excess carrier became liable.[161] In reversing summary judgment for the insured the court held that "the duty of good faith and fair dealing was owed to the excess insurer both by Kaiser, the excess insured, as well as by Lloyd's the primary insurer."[162] Subjecting both the insured and the pri-

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154. *See* Griffin, *supra* note 16, at 379. *See also* St. Paul Fire & Marine Ins. Co. v. Allstate Ins. Co., ___ Mont. ___, ___, 847 P.2d 705, 709 (1993) (court implied that it would adopt equitable subrogation between primary and excess insurers).

155. *See supra* text accompanying notes 61-68.

156. Certain Underwriters of Lloyd's v. General Accident Ins. Co., 909 F.2d 228, 233 (7th Cir. 1990).

157. Maine Bonding & Casualty Co. v. Centennial Ins. Co., 693 P.2d 1296, 1299 (Or. 1985).

158. *See* Russo v. Rochford, 472 N.Y.S.2d 954, 962 (App. Div. 1984).

159. 153 Cal. Rptr. 678 (Ct. App. 1979).

160. *Id.* at 682.

161. *Id.* at 680.

162. *Id.* at 682. It is important to note that the insured's duty of good faith and fair dealing to the excess insurer was expressly limited by the California Supreme Court when it held that "the insured status as such is not a license for the insured to engage in unconscionable acts which would subvert the legitimate rights and expectations of the excess insurance carrier." Commercial Union Assurance Cos. v. Safeway Stores, Inc., 610 P.2d 1038, 1043 (Cal. 1980).

mary insurer to the duty of good faith and fair dealing minimizes costs to everyone by encouraging cooperation.[163]

The policy reasons behind imposing a direct duty were best articulated by the Illinois Federal District Court in *Ranger Insurance Co.*:

> [These reasons] include the encouragement of settlements when an offer exists at or near the policy limits, discouraging gambling with the excess carrier's money, hoping to keep excess liability insurance premiums low, reducing the necessity for the excess carrier to participate in the defense of the action to protect its rights, and reflecting the duties of the primary carrier to perform the duty which it has delegated to itself, that is, providing primary coverage.[164]

These policy justifications reflect the expectations of the parties. Additionally, the primary carrier can foresee that its bad faith conduct will injure the excess carrier.

The third step in the bad faith analysis is to determine which duty or duties the primary carrier failed to perform.[165] The primary carrier can easily determine the duties owed to the excess carrier; these duties are essentially the same duties that the primary carrier owes the insured.[166] Therefore, the type of conduct that subjects the primary insurer to a bad faith claim by the insured should subject the primary insurer to a bad faith claim by the excess insurer. The court can use the tort concept of foreseeable harm to determine whether the bad faith conduct of the primary insurer injured the excess insurer. Thus, the well-established bad faith guidelines in Montana case law would guide a primary insurer's relationship with an excess insurer.[167]

VI. CONCLUSION

The Montana Supreme Court will inevitably face the issue of

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163. *See Maine Bonding*, 693 P.2d at 1302 ("Relieving the primary insurer of its duty to diligently defend in those cases in which excess coverage and excess exposure exist may give the primary insurer a disincentive to settle."). *See also* Story v. City of Bozeman, 242 Mont. 436, 450, 791 P.2d 767, 775 (1990) (holding "that every contract, regardless of type, contains an implied covenant of good faith and fair dealing").

164. *Ranger Ins. Co.*, 714 F. Supp. at 961 (quoting R. LONG, THE LAW OF LIABILITY INSURANCE § 5.63 at 5-472 (1980) (alteration in original).

165. *See supra* text accompanying note 94.

166. 14 MARK S. RHODES, COUCH ON INSURANCE § 51:27 (rev. 2d ed. 1983 & Supp. 1992). *See also supra* text accompanying note 95.

167. *See* Gibson v. Western Fire Ins. Co., 210 Mont. 267, 682 P.2d 725 (1984). *See also* Jessen v. O'Daniel, 210 F. Supp. 317 (D. Mont. 1962).

bad faith between a primary carrier and an excess carrier.[168] After deciding whether a primary-excess relationship exists between the insurance carriers, the court must choose a legal theory to determine the validity of the bad faith claim. The appropriate legal theory in support of this cause of action should be a direct duty flowing between the primary and the excess carrier. This would allow the court to use currently defined standards to measure the parties' conduct and apportion liability. The standards used to measure the primary carrier's conduct towards the excess carrier should be the same standards used to measure the primary carrier's conduct towards the insured. In limited situations, misconduct by the insured, amounting to a breach of good faith and fair dealing against the excess carrier should support a recovery by the excess carrier from the insured.[169] Imposing duties on the insured and the primary carrier protects the excess carrier against events over which the excess carrier may have little or no control over.

168. *See* St. Paul Fire & Marine Ins. Co. v. Allstate Ins. Co., ___ Mont. ___, ___, 847 P.2d 705, 709 (1993) (although not in the primary-excess context, the court denied the underinsurer's bad faith claim under equitable subrogation because the underinsurer's insured had already asserted the bad faith claim).

169. *See* Kaiser Found. Hospitals v. North Star Reinsurance Corp., 153 Cal. Rptr. 678, 682 (Ct. App. 1979).